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Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

BOB REVES, *et al.*,
Petitioners,
v.
ERNST & YOUNG,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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BRIEF FOR THE RESPONDENT

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QUESTIONS PRESENTED

1. Whether the court below was correct in affirming the district court's grant of summary judgment for respondent on petitioners' claim under the Racketeer Influenced and Corrupt Organizations Act on the ground that respondent, an independent public accounting firm, did not "conduct or participate, directly or indirectly, in the conduct of" the affairs of an alleged RICO enterprise within the meaning of 18 U.S.C. § 1962(c) merely by (1) performing audits of its client's annual financial statements, (2) meeting with the client's board of directors to explain the audits, and (3) making oral presentations at the client's annual meetings.

2. Whether petitioners' RICO claim must fail because of their inability to show that respondent's performance of two audits of its client's financial statements, in which it was found to have fraudulently overstated the carrying value of a single asset, satisfies RICO's requirement that the defendant have engaged in a *pattern* of racketeering activity.

PARTIES TO THE PROCEEDING

In addition to the parties listed in the caption, Thomas E. Robertson, Jr., as Trustee of the Farmers Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, appeared in the proceedings below as a plaintiff/appellee and plaintiff/cross-appellant; and Robert R. Cloar, Class Counsel, was an appellant.

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BRIEF FOR THE RESPONDENT

STATUTE INVOLVED

The pertinent provision of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962, is set forth in an appendix to this brief.

STATEMENT

This case presents the question whether the Eighth Circuit was correct in affirming the district court's grant of summary judgment for respondent on petitioners' RICO claim. The essence of that claim is that respondent, an independent public accounting firm that issued audit opinions on the 1981 and 1982 financial statements of the Farmers Co-op of Arkansas and Oklahoma, Inc. ("Co-op"), participated in the conduct of the Co-op's affairs, and specifically its demand note program, through a pattern of racketeering activity consisting of securities fraud. The court of appeals held that respondent's activities, which consisted of performing audits of the Co-op's financial statements, meeting with the Co-op's board of directors to explain the audits, and making oral presentations at the Co-op's annual meetings, did not satisfy the "participation" requirement of 18 U.S.C. § 1962(c). J.A. 275.

Petitioners recognize that these activities are plainly insufficient to bring respondent's actions within the reach of Section 1962(c). *See, e.g.*, Br. 27 ("this is not a case of the typical auditor, who does nothing more than audit, and perhaps leave unchallenged, fraudulent materials invented and used by an issuer's management as part of their fraudulent scheme"); *see also id.* at 23-24, 29. Thus, petitioners devote virtually their entire brief to rearguing the merits of their securities law claims (which are not before the Court) in an attempt to demonstrate that what the courts below found to be auditing activity was not auditing activity at all. Petitioners' statement of the case improperly ventures far beyond the summary judgment

record[1] in an effort to establish that respondent "stopped being an auditor and *de facto* made key decisions and took key actions to falsify the Co-op's records, hide its insolvency, hide the frauds of third parties, fraudulently keep securities sales going, and mislead Co-op members, Board, and management." *Id.* at 29. As we show below, the decisions of the district court and the Eighth Circuit on a fully developed summary judgment record reveal these contentions to be false.

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[1] It is well established that review of a grant of summary judgment is limited to an examination of the record before the district court at the time that its ruling was made. *See, e.g., Savers Fed. Savings & Loan Ass'n v. Reetz*, 888 F.2d 1497, 1501 n.4 (5th Cir. 1989); *Frito-Lay, Inc. v. Willoughby*, 863 F.2d 1029, 1035-1036 (D.C. Cir. 1988); *Vontour v. Vitale*, 761 F.2d 812, 817 (1st Cir. 1985), *cert. denied*, 474 U.S. 1100 (1986). Petitioners attempt to justify their departure from this rule on the ground that:

> After all trial evidence was admitted, plaintiffs moved for and the judge *granted* reconsideration of the pre-trial summary judgment on RICO issues. The trial court then reaffirmed its earlier ruling based on the combined trial and pre-trial record. (Trans. XV: 48-51.)

Br. 2 n.2 (emphasis added). This is not what happened. The transcript pages cited by petitioners reveal instead that the district court *denied* rather than granted petitioners' motion for reconsideration, and did so because it believed that submission of the RICO claim would prejudice the jury's consideration of the remaining claims. There is nothing to suggest that the district court assessed the evidence elicited at trial and determined that it fell short of what the "conduct" element of Section 1962(c) requires. Nor is there anything in the Eighth Circuit's opinion to suggest that it departed from fundamental principles of appellate review when it affirmed the district court's grant of summary judgment.

At bottom, much of the trial evidence on which petitioners improperly rely is simply an elaboration of the summary judgment evidence and to that extent petitioners' error may be harmless. What is not harmless, however, are petitioners' mischaracterizations of the trial record in an attempt to portray respondent as utterly corrupt. Accordingly, respondent believes that it is appropriate to correct at least the most serious misimpressions that petitioners have attempted to convey. However, matters that were not before the district court when it entered summary judgment are not properly before this Court and should not be considered.

1. *The Co-op and Its Demand Note Program.* This case arises out of the 1984 bankruptcy of the Co-op. The Co-op was organized in 1946 and was conducting extensive business operations in western Arkansas and eastern Oklahoma by the late 1970's. Beginning in 1959, the Co-op raised capital to support its general business operations by selling promissory notes payable on demand of the holder. These demand notes were uncollateralized and uninsured, but were attractive to investors because they paid a higher rate of interest than the rates offered by local financial institutions. J.A. 232.

The Co-op advertised the demand note program in its monthly newsletter. For many years that advertisement stated that "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is * * * Safe * * * Secure * * * and available when you need it." C.A. Jt. App. 1820 (ellipses in original). It is undisputed that respondent had no involvement with the Co-op's newsletter. Tr. Vol. X at 165.

It is also undisputed that respondent "played no active role in the purchase of demand notes." J.A. 307; *id.* at 150-167. In granting summary judgment to respondent on petitioners' claims alleging the sale of unregistered securities, the district court held that the record would not support a finding that respondent (i) was in privity with any of the demand note purchasers (J.A. 156); (ii) was "a substantial factor in causing any one sale to take place" (*ibid.*); (iii) "commanded, directed, advised or encouraged the sale of unregistered demand notes" (*id.* at 158); or (iv) conspired with others to sell the demand notes (*id.* at 159-163). According to the district court, "[t]he sales had been going on for two decades before any of these gentlemen arrived on the scene. The most that can be said is that they failed to advise against the sales." *Id.* at 158-159.

2. *Arthur Young's Audit Opinions.* Arthur Young & Company was first retained as the Co-op's independent

auditor in 1981.[2] It subsequently issued audit reports on the Co-op's financial statements for the years ending December 31, 1981 and December 31, 1982. Upon assuming its duties as the Co-op's auditor, Arthur Young was required to address a number of accounting issues. One major issue—and the principal basis for petitioners' securities fraud claims—related to the appropriate basis of accounting for a gasohol plant that was owned by the Co-op through its wholly-owned subsidiary, White Flame Fuels, Inc. ("White Flame").

In 1979, the Co-op's general manager, Jack White, had joined with another individual to finance and construct the gasohol plant. Each invested $125,000 of his own funds and acquired 50% of the stock in White Flame. Construction of the plant began in June 1979. Four months later, White purchased the other 50% interest in White Flame. Beginning in January 1980, White arranged for White Flame to obtain loans from the Co-op to finance the continued construction and the initial operation of the plant. White personally guaranteed these loans. The plant began producing gasohol in April 1980, but was soon beset by problems stemming from its poor design and from economic factors such as the falling price of oil. White Flame continued to obtain loans from the Co-op to cover the plant's operating costs. By December 1980, the loans totalled approximately $4 million. Eventually, the Co-op's board of directors voted to purchase all of the stock of White Flame in exchange for the Co-op's assumption of White's $4 million debt. J.A. 233-235.

The proper accounting treatment for the gasohol plant depended on whether the Co-op had in substance owned the plant from the beginning of its construction. If so, the plant could be carried at historical cost, approximately $4.5 million. If not, the proper carrying value would have

[2] In 1989, Arthur Young and Ernst & Whinney combined to form the firm of Ernst & Young, which is the respondent in this case. Because the events at issue occurred prior to 1989, we will refer to respondent as Arthur Young.

been the fair market value of the plant at the time of transfer, which subsequently was estimated to have been between $444,000 and $1.5 million. J.A. 242, 245 & n.7. Although the stock of White Flame was originally owned by White and his partner, Arthur Young concluded that the correct accounting treatment under generally accepted accounting principles ("GAAP") was for the Co-op to carry the plant at its historical cost of $4.5 million because in substance the Co-op had owned the plant from its inception: it had been constructed primarily with funds borrowed from the Co-op and was built by Co-op employees. *Id.* at 243; Tr. IX at 224, 225-226.[3] Because the Co-op's balance sheets for 1981 and 1982 reflected a net worth of only $2.6 million and $1.3 million, respectively, carrying the plant at a fair market value of $1.5 million or less instead of historical cost of $4.5 million would have resulted in the Co-op's balance sheets showing a negative net worth. J.A. 245.

Petitioners fail to point out that, although Arthur Young concluded that recording the gasohol plant at its historical cost was appropriate under GAAP, it also concluded, because of uncertainty over the recoverability of the cost of the plant, that it could not express an opinion on whether carrying the plant at historical cost fairly presented the financial condition of the Co-op. Arthur Young therefore issued *qualified opinions* on both the 1981 and 1982 financial statements. The 1981 audit report stated (J.A. 246; C.A. Jt. App. 235):

> As discussed in Note 9 to the consolidated financial statements, there is some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations. Man-

[3] Petitioners' accounting expert testified at trial that it is a fundamental principle of accounting that the treatment of a transaction should reflect its economic substance (Tr. Vol. XIV at 245-246), and that in determining the carrying value of the gasohol plant he too had looked beyond the legal form of the Co-op's acquisition of the plant to assess the economic substance of the transaction. *Id.* at 246-247.

agement has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statements.[4]

The audited financial statements also revealed other negative information concerning the Co-op's financial condition. In particular, they indicated that the Co-op's current liabilities were approximately double its current assets and that the Co-op had suffered net losses of $1.4 million in 1981 and $1.2 million in 1982. C.A. Jt. App. 238-240, 261-263. Arthur Young presented its audit reports to the Co-op's board of directors, thus putting the board on full notice of the Co-op's deteriorating financial condition. *See* pp. 10-11, *infra*.

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[4] Footnote 9 to the Co-op's 1981 financial statements addressed the accounting for the gasohol plant and the economic prospects of the Co-op (J.A. 247; C.A. Jt. App. 251-252):

> Financing of the initial construction and subsequent major revisions which totaled approximately $4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately $5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover the operating losses of White Flame Fuels, Inc. (currently averaging $100,000 per month) until such time that improvements in marketing conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investment in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

Arthur Young's audit report on the Co-op's 1982 financial statements contained the same qualification as its 1981 report, and the 1982 financial statements themselves, in footnote 8, provided updated information on White Flame's worsening financial condition and the resulting uncertainty about the Co-op's ability to recover its investment. J.A. 255-256; C.A. Jt. App. 258, 272-273.

3. *Petitioners' Allegations of Respondent's Participation in the Conduct of the Co-op's Affairs.* Relying in large part on evidence adduced at trial (*see* note 1, *supra*), petitioners contend that respondent's activities included more than merely auditing the Co-op's financial statements. Petitioners' central thesis is that Arthur Young engaged in a series of frauds all intended to shield Jack White (who had been instrumental in the Co-op's decision to hire Arthur Young as its auditor) from scrutiny for prior misdealings with the Co-op. Petitioners' premise is wholly illogical and flies in the face of the evidence in several respects. What petitioners have failed to disclose bears emphasis here: *first*, that on a whole series of audit conclusions reached by Arthur Young—conclusions that revealed the Co-op's financial position to be far worse than Jack White wished it to be—White vehemently disagreed with Arthur Young;[5] and *second*, that Arthur Young also brought instances of White's suspected self-dealing to the attention of the Co-op's board.[6] Against this backdrop, we address the four areas in which petitioners contend that Arthur Young's conduct went beyond mere auditing.

a. The Creation of Financial Data and Records. There is no record support for petitioners' contention (Br. 23-

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[5] The most significant dispute concerned the proper balance sheet classification of the demand notes. Prior auditors had permitted the Co-op to classify only 20% of the outstanding demand notes as current liabilities (liabilities payable within one year) on the theory that many note holders elected not to demand payment on their notes during the course of a year. C.A. Jt. App. 287, 296. Arthur Young concluded that this treatment violated GAAP and indicated that it would take exception to it in its 1981 report. Ultimately, all of the demand notes were classified as current liabilities. As a result of this and other disputes, White unsuccessfully sought to fire Arthur Young and to have another accounting firm conduct the audit of the Co-op's 1981 financial statements. *Id.* at 301.

[6] For example, White sought to claim the cash value of life insurance policies owned by the Co-op and to obtain payments for certain properties that he previously claimed to have contributed to the Co-op. Arthur Young brought these matters to the attention of the board of directors, which ultimately acceded to White's demands on both issues. Tr. Vol. X at 162-164; Tr. Vol. XI at 178-179.

24) that Arthur Young created "fundamental financial data" and used it "to prepare books, records, and financial statements." Although Arthur Young drafted the financial statements of the Co-op, the draft financial statements were based on the records maintained by the Co-op itself or its subsidiary, White Flame Fuels. Tr. Vol. IX at 180-185, 225-232, 236-239; Tr. Vol. X at 172-185.[7] Drafting a client's financial statements is in full accord with generally accepted auditing standards ("GAAS"), which were before the district court when it granted Arthur Young's motion for summary judgment.[8] Arthur Young created no other Co-op documents. It is undisputed that Arthur Young's role as the Co-op's audi-

[7] *See also* Appendix and Exhibits to the Reply Memorandum of the Arthur Young Defendants in Support of Their Motion for Summary Judgment, Nos. 85-2404, 2096, 2155 & 2256 (W.D. Ark. filed September 15, 1986) ("Reply Mem. Exhibits"), Vol. I at 12. Ironically, petitioners' contention that Arthur Young "creat[ed] fundamental financial data" (Br. 23) is wholly undercut by their citation to the district court's opinion (Br. 13, *quoting* J.A. 140-141) finding, in connection with petitioners' common law fraud and negligence claims, that it was not plausible to suppose that Arthur Young could have "independently" arrived at a cost of construction for the gasohol plant of $4,393,242.66—the exact same figure arrived at by the Co-op's former internal accountant, Gene Kuykendall. Thus, whether the figure was right or wrong, it was "created" not by Arthur Young but by the Co-op's internal accountant.

Similarly, petitioners are wrong in asserting (Br. 9) that the decision on how to value the gasohol plant was made "unilaterally" by Arthur Young. Arthur Young's audit judgments were reached after consultation with Jack White, Kirit Goradia, the Co-op's chief financial officer, and individuals who had worked at the plant. Tr. Vol. IX at 227-229. Goradia, among others, agreed with the way in which the plant was valued in the Co-op's financial statements. Tr. Vol. X at 21-23, 172-185.

[8] Reply Mem. Exhibits, Vol. I at 12. The applicable professional standard provides in relevant part that while "[t]he financial statements are management's responsiblity * * * [t]he independent auditor may make suggestions about the form or content of the financial statements *or draft them, in whole or in part, based on information from management's accounting system.*" [1 CCH] AICPA, *Professional Standards*, Statements on Auditing Standards ("SAS") No. 1, AU § 110.02 (emphasis added).

tor was to examine its client's records, to subject them to test procedures where circumstances warranted, and to reach accounting judgments based on the records and the data they contained.[9] There is no evidence that Arthur Young departed from this role in auditing the Co-op's financial statements.

b. "Absentee Management." Petitioners strive mightily to create the impression that the Arthur Young audit engagement team constituted the *de facto* management of the Co-op. In fact, during all relevant times, the Co-op had its own management team in place. During the 1981 audit, Jack White and Kirit Goradia were, respectively, the general manager and chief financial officer of the Co-op. Tr. Vol. IX at 166.[10] Petitioners again distort

[9] The summary judgment record contained the deposition testimony of petitioners' accounting expert that an auditor begins his examination based on the data recorded in the audit client's records, and then performs whatever special procedures he believes necessary with respect to that data. Reply Mem. Exhibits at 12. At trial, petitioners' expert testified that the Arthur Young auditors placed little reliance on the internal accounting controls of the Co-op and conducted a substantial amount of substantive audit testing, particularly in confirming the demand notes reported outstanding on the Co-op's books and in testing inventory compilation—two areas in which the Co-op's general manager, Jack White, had been accused of fraud. Tr. Vol. XIV at 241-242.

[10] White's conviction for tax fraud involving self-dealing with the Co-op does not change the fact that he was nonetheless the Co-op's general manager until the Board removed him in 1982. His conviction simply required Arthur Young to engage in substantially more extensive testing of the Co-op's books and records than might otherwise be the case. The record reflects that Arthur Young did exactly that. *See* n.9, *supra;* Tr. Vol. X at 157-158, 170-172; Tr. Vol. XI at 154-157, 186-187.

Similarly, Goradia's failure to sign the management representation letter in 1982 does not negate the fact that he was still the Co-op's chief financial officer. (Among other things, Goradia was the person who prepared the Co-op's condensed financial statements for distribution at its annual membership meetings. *See* pp. 12-14, *infra.*) The Co-op's general manager at the time of the 1982 audit, Fred Howard, signed the letter. J.A. 254. Accordingly, Arthur Young did not view Goradia's failure to sign the letter as a refusal

the record in contending (Br. 29) that White "went to jail before Arthur Young drafted the first Co-op financial report and statement." As petitioners acknowledge, White went to prison in April 1982 (Tr. Vol. XII at 25) and the uncontested testimony at trial established that a draft of the Co-op's 1981 financial statements was completed by mid-March 1982 (Tr. Vol. X at 33). During the 1982 audit, Fred Howard had replaced Jack White as general manager, and Athur Young consulted with Howard regularly thereafter. Tr. Vol. X at 137-139. In the course of their work, Arthur Young's auditors reviewed and explained the Co-op's financial statements and Arthur Young's audit reports to the Co-op's management before they were submitted to the board of directors for approval. Tr. Vol. X at 35-36.

c. Arthur Young's Meetings with the Co-op's Board of Directors. Continuing on with their theme that Arthur Young somehow took over the Co-op, petitioners contend (Br. 18) that "Arthur Young met the directors, handed them a report, and tried to hurry them to approve it," clearly implying that Arthur Young failed to inform the Co-op's board of the financial problems that faced the Co-op, and specifically the problems posed by the gasohol plant. That contention too is belied by the record, which demonstrates that even though Arthur Young did not specifically describe the accounting principle used to report the cost of the gasohol plant, it clearly disclosed to the board the financial drain on the Co-op that the plant represented, the serious doubts that existed as to the recoverability of the Co-op's investment in the plant, and other major financial problems facing the Co-op. These meetings occurred on April 22 and July 1, 1982 and lasted for a total of five and one-half hours. Tr. Vol. XI at 203, 248-249; C.A. Jt. App. 434-437.

by "management" to sign the representation letter, especially because the Arthur Young auditors had confidence in Fred Howard, with whom they had frequent discussions concerning the Co-op. Tr. Vol. X at 138-139; Tr. Vol. XI at 185. (Arthur Young mistakenly believed that it had secured a management representation letter with respect to the 1981 audit. J.A. 255 n.10.)

During its April 22, 1982 meeting with the board, Arthur Young reviewed its audit report in detail. Tr. Vol. XI at 200-203; Tr. Vol. XII at 101. This review included the footnote disclosures concerning the gasohol plant. C.A. Jt. App. 250-252; Tr. Vol. X at 111, 200-205. Arthur Young discussed the recoverability problem with the board, indicating not only that the plant might at some point need to be written down, but also that the Co-op would be required to (i) obtain projections and analyses concerning the future use of the plant from qualified specialists (C.A. Jt. App. 235, 250-252; Tr. Vol. XI at 175-176, Tr. Vol. XII at 31-36), and (ii) obtain an appraisal of the plant's worth based on those projections and analyses. C.A. Jt. App. 235, 250-252; Tr. Vol. X at 193-96, 200-206. The board was informed that the Co-op had no basis to write down the plant's value in the absence of the needed data. C.A. Jt. App. 235, 250-252; Tr. Vol. X at 193-196. Arthur Young also explained the perils of relying on the demand note program for financing and urged the board to restructure its debt by obtaining longer term financing. Tr. Vol. IX at 187-88; 192-93; Tr. Vol. X at 95, 166, 207-208. Arthur Young believed that these problems were understood by the board (Tr. Vol. XI at 228-229), and when its meetings with the board concluded, according to the testimony of one of the directors, there were no questions left. Tr. Vol. XI at 203-204; Tr. Vol. XII at 31-35, 40-41.

d. The 1982 and 1983 Annual Meetings and the Condensed Financial Statements. The final way in which petitioners contend that Arthur Young supposedly strayed beyond the role of an auditor involves nothing more than Arthur Young's attendance at the Co-op's annual membership meetings to comment on financial matters. *See* Br. 24. An auditor's attendance at his client's annual meetings for such purposes is, of course, a routine matter that is an entirely logical follow-up to the audit engagement itself. *See* p. 41, *infra*. In any event, petitioners' account of Arthur Young's brief appearances at the 1982 and 1983 annual meetings is incomplete. The full record reveals the following information.

Representatives of Arthur Young made oral comments on the financial condition of the Co-op at its annual meetings in May 1982 and March 1983. At these meetings, condensed financial statements prepared by the Co-op's management were distributed to the audience. At the beginning of their oral presentations, Arthur Young's representatives informed the members of the audience that they had received only condensed financial statements and that copies of the full audited statements were available at the Co-op's offices. J.A. 250, 258. The condensed financial statements did not include the qualifications in Arthur Young's audit reports or the footnote disclosures concerning the gasohol plant. *Id.* at 249, 258.

The condensed statement of operations handed out at the 1982 meeting did not incorporate the gasohol plant operations and therefore reflected a net profit of $154,000. C.A. Jt. App. 231. The condensed balance sheet included the gasohol plant valued at historical cost and therefore reflected net members' equity of $2.6 million. J.A. 249. During the course of the oral comments by Arthur Young's representative, the audience soon began asking questions concerning White Flame and its financial status. Petitioners err in asserting (Br. 16-17) that Arthur Young's representative "corrected no errors and evaded all questions."[11] During these interchanges, White

[11] Petitioners also misstate the record in claiming (Br. 16) that "Arthur Young knew at that time that the condensed financial statements were misleading * * *." The record is clear that Arthur Young's representative at the meeting, Harry Erwin, had Arthur Young's full audit report with him, had received the condensed financial statements only when he arrived at the meeting, and had no advance preparation as to the condensed statements' contents. J.A. 250; Tr. Vol. XII at 107. The testimony cited by petitioners (Tr. Vol. XI at 125, 146-147) relates to the observation of an Arthur Young representative, Mr. Cabaniss, concerning the condensed statements to be presented at the *1983* annual meeting. Cabaniss testified that he realized the condensed statements presented at the *1982* meeting were misleading only *after* the meeting had occurred. Tr. Vol. XI at 101. In preparation for the 1983 meeting, Cabaniss therefore informed the Co-op's general manager, Fred Howard, that condensed statements would be misleading without Arthur Young's full report and footnote disclosures. Tr. Vol. XI at 147-148.

Flame's $1.2 million loss in 1981 was disclosed to the audience. J.A. 250-251. Arthur Young's representative also disclosed: (i) that the Co-op's condensed statements did not include the $1.2 million loss (Tr. Vol. XII at 108-09); (ii) that the net worth of the Co-op had fallen $1.8 million over the previous year (Tr. Vol. XII at 109); and (iii) that the Co-op had invested more than $4 million in the gasohol plant by the end of 1980, and that figure had risen to approximately $5 million by the end of 1981. Tr. Vol. XII at 133.

In advance of the 1983 annual meeting, the Co-op's general manager, Fred Howard, suggested distributing Arthur Young's audit report, including the Co-op's financial statements, to attendees at the 1983 meeting, but without the footnote disclosures concerning the gasohol plant. Arthur Young informed Howard that the financial statements would be misleading without the footnotes and instructed him that Arthur Young's report and the accompanying financial statements should not be condensed. Tr. Vol. XI at 147-148; 225-227. Arthur Young also informed Howard and Kirit Goradia that Arthur Young's name should not appear on any condensed financial statements because such statements would not be Arthur Young's, and that the proper course was to provide the meeting attendees with Arthur Young's report and a complete set of financial statements, including the footnotes. J.A. 257; Tr. Vol. X at 123; Tr. Vol. XI at 148, 225-226. The Co-op's management did not follow Arthur Young's advice: shortly before the 1983 meeting, Arthur Young's representative received a copy of the Co-op's condensed statements, which indicated that the information was condensed from Arthur Young's report. J.A. 257. At the meeting, Arthur Young's representative again informed the audience that the full audited financial statements were available at the Co-op's offices. J.A. 258.

Although the condensed financial statements distributed by the Co-op at the 1983 meeting did present more completely the Co-op's rapidly worsening financial condition, they again omitted the qualification in Arthur Young's audit opinion and the footnote disclosure on the gasohol

plant. J.A. 258. The condensed statement of operations for the 1983 annual meeting did include the gasohol plant and reflected losses of $1.4 million in 1981 and $1.2 million in 1982. C.A. Jt. App. 233. In addition, the balance sheet reflected current assets of only $6.9 million to cover current liabilities of $15.3 million. *Id.* Net members' equity had dropped from $2.6 million to approximately $1.4 million. *Id.*

4. *The Proceedings Below.* In February 1984, the Cooperative Finance Association ("CFA") refused to advance additional funds on a line of credit it had provided to the Co-op because the level of demand note financing had dropped slightly below the amount required by the terms of the credit agreement. CFA's denial of additional credit forced the Co-op to file for bankruptcy. J.A. 259-260. Less than a year later, the Co-op's bankruptcy trustee filed an action in the United States District Court for the Western District of Arkansas on behalf of the Co-op and certain demand note holders against forty individuals and entities, including Jack White, members of the Co-op's board, several of the Co-op's lawyers, Arthur Young, and the two auditors that had preceded Arthur Young. The complaint alleged a wide variety of federal and state causes of action, including common law fraud and negligence, violations of the registration and disclosure provisions of the Arkansas Securities Act, violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, violations of the registration provisions of the Securities Act of 1933, and violations of RICO, 18 U.S.C. §§ 1961-1968. Subsequently, the district court certified a plaintiff class consisting of persons who purchased demand notes between February 15, 1980, and February 23, 1984. J.A. 262.

Petitioners alleged in their complaint that Arthur Young had conducted or participated in the conduct of the affairs of the Co-op through a pattern of racketeering activity consisting of mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c). J.A. 273-274. After the close of discovery, Arthur Young moved for summary

judgment on this claim, urging two grounds: first, that petitioners could not establish that Arthur Young had conducted or participated in the conduct of the Co-op's affairs within the meaning of Section 1962(c); and, second, that petitioners could not demonstrate that Arthur Young had engaged in a pattern of racketeering activity as required by the statute. J.A. 198. The district court granted Arthur Young's motion, holding that under the Eighth Circuit's decision in *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), *cert. denied*, 464 U.S. 1008 (1983), mere participation in auditing activities is insufficient to constitute participation in the conduct of the affairs of a RICO enterprise under Section 1962(c). The district court held (J.A. 199-200):

> Plaintiffs have failed to show anything more than that the accountants reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status as of a date three or four months preceeding (*sic*) the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management required by *Bennett v. Berg*, *Id.*[12]

Prior to trial, all defendants except Arthur Young and White's lawyers settled the claims against them. J.A. 262. (White's lawyers settled after trial. J.A. 262 n.13.) After a month-long trial, the jury found that Arthur

[12] Petitioners also argued to the district court that the Arthur Young auditors had operated *Arthur Young* through a pattern of racketeering activity. J.A. 211-212. Under this theory Arthur Young, rather than the Co-op, was the alleged RICO enterprise. The district court rejected that contention, noting that while the individual Arthur Young auditors had obviously participated in the management of Arthur Young, there was no proof that Arthur Young's "affairs" had been conducted through a pattern of racketeering activity. The court noted that to the extent Arthur Young's dealings with the Co-op were wrongful, "such dealings are aberrant, and in no way 'typical' of the practice of these professionals." *Id.* at 212-213. Petitioners did not appeal that determination to the Eighth Circuit, and it is not an issue before this Court.

Young had committed primary violations of Section 10(b) and secondary violations of the Arkansas securities statute. J.A. 265. The jury rejected the Trustee's claim that Arthur Young was guilty of fraud in the performance of the audits. J.A. 265 n.15 On the Trustee's negligence claim, the jury found that Arthur Young was guilty of negligence in the performance of the Co-op's audits, but also found that the Co-op "was guilty of contributory negligence which interfered with Arthur Young's audit and which caused proximate damages to the Co-op" J.A. 265 n.15; Tr. Vol. XX at 5-6. The jury apportioned 50% of the responsibility to Arthur Young and 50% to the Co-op, which barred recovery under Arkansas law. *Id.* at 6.

Both Arthur Young and petitioners appealed the district court's judgment to the United States Court of Appeals for the Eighth Circuit. In its first opinion in this case, the court of appeals held that the demand notes were not securities under federal and Arkansas law and reversed the district court's judgment. *Arthur Young & Co. v. Reves*, 856 F.2d 52 (1988). This Court granted certiorari and reversed the judgment of the Eighth Circuit, holding that the demand notes were securities under federal law. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

On remand, the court of appeals concluded that the demand notes were securities under Arkansas law as well and affirmed the district court's judgment that Arthur Young had committed primary violations of Section 10(b) and was secondarily liable for violations of the Arkansas Securities Act. The court of appeals also affirmed the district court's grant of summary judgment to Arthur Young on petitioners' RICO claim. Viewing the evidence in the light most favorable to petitioners, J.A. 274, the court held that Arthur Young's involvement with the Co-op did not rise to the level of participation in the conduct of the Co-op's affairs required under Section 1962(c). On that issue, the court applied its prior ruling in *Bennett*, in which it had stated that "'[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself.'" J.A. 275 (*quoting Bennett*, 710 F.2d at 1364). Recognizing that "Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings," J.A. 275, the court of appeals concluded that that activity fell short of what *Bennett* requires.

SUMMARY OF ARGUMENT

Both courts below unequivocally held that Arthur Young's activities as the Co-op's independent auditor in no way rose to the level of participation in the operation or management of the Co-op and therefore did not constitute participation in the conduct of the Co-op's affairs. Petitioners and their amici vigorously attack the Eighth Circuit's "operation or management" test, yet they are singularly unsuccessful in their efforts to propose a viable alternative. All of the proposed tests suffer from inherent flaws—some are clearly incorrect because they effectively eliminate key portions of the statutory language; others are of no use because they merely substitute one set of dictionary definitions for another. At bottom, all of these tests are simply an appeal to let prosecutors and juries decide RICO's coverage on an *ad hoc* and subjective basis, a state of affairs that would not pass constitutional muster.

In the end, like petitioners and the Government, we are unable to suggest any bright-line test that will, in all cases, provide meaningful guidance for determining at what point the activities of independent providers of services (or goods) to a legitimate company rise to the level of participation in the conduct of the company's affairs. What we *can* say, however, is that the Eighth Circuit's operation or management test is faithful to the statutory language and purpose and provides reasonable guidelines for interpreting the statutory language in the

specific context of independent auditors. However it may apply across the board, the Eighth Circuit's test excludes outside accountants who limit their involvement with a client to traditional auditing activities. Thus, the Court can easily dispose of this case by affirming the straightforward ruling of the court of appeals on this issue.

Alternatively, the Court could affirm the judgment below on the basis that respondent's audits of the Co-op's 1981 and 1982 financial statements did not, as a matter of law, constitute a "pattern of racketeering activity" under RICO. Respondent presented the "pattern" argument to both courts below, but neither court found it necessary to address the point because of their conclusion that the "conduct" requirement had not been satisfied. Nonetheless, the gravamen of petitioners' securities fraud claims is that Arthur Young fraudulently overstated the carrying value of a single asset of a single company in its first year of auditing, and then simply repeated the same mistake the following year. That claim lacks the essential element of "continuity" that is required by RICO and this Court's precedents.

If, however, the Court is not satisfied with either of these limited holdings and wishes to articulate a more comprehensive rule, we respectfully submit that it will find itself left with little choice but to conclude that RICO's conduct requirement, like other parts of the statutory language, defies every attempt to develop reasonable guidelines that comprehensively distinguish between conduct that was intended to be covered by RICO's draconian sanctions and conduct that was intended to be excluded. In the final analysis, therefore, the more appropriate alternative may be the one suggested by Justice Scalia in his concurring opinion in *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 254-256 (1989). If the Court were to strike down Section 1962(c) as unconstitutionally vague, Congress might at last be persuaded that persons of ordinary (and even extraordinary) intelligence have been left to guess at RICO's intended meaning for far too long.

ARGUMENT

I. THE COURT OF APPEALS CORRECTLY RULED THAT LIABILITY UNDER U.S.C. § 1962(c) REQUIRES SOME PARTICIPATION IN THE OPERATION OR MANAGEMENT OF THE RICO ENTERPRISE

A. The Standard Applied By The Court Below Is Not "Control" But Rather "Some Participation In The Operation Or Management" Of The RICO Enterprise

Respondent submits that the issue before the Court is narrow: whether an independent public accounting firm "conduct[s] or participate[s], directly or indirectly, in the conduct of" the affairs of an alleged RICO enterprise within the meaning of 18 U.S.C. § 1962(c) merely by engaging in audits of its client's annual financial statements and activities relating thereto (in this case, meetings with the client's board of directors and presentations at annual membership meetings). In concluding that as a matter of law there was no violation of RICO on these facts, the Eighth Circuit held that "'[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself.'" J.A. 275, *quoting Bennett*, 710 F.2d at 1364.

Petitioners and their amici largely ignore this holding and instead mount an attack on a quite different standard, "control," which they derive from *Yellow Bus Lines, Inc. v. Drivers Local Union 639*, 913 F.2d 948 (D.C. Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 2839 (1991). Indeed, according to petitioners and the United States, the question presented is whether the Eighth Circuit erred in requiring "proof that the defendant *control* the management or operation of the enterprise." Pet. Br. i (emphasis added); U.S. Br. I; *see also* Pet. Br. 19, 31; U.S. Br. 7, 9. That language is nowhere to be found in the Eighth Circuit's opinion in this case or in its prior decision in *Bennett*.

Ultimately then, all references to "significant control," "running the show" and "corporate boardrooms" (U.S. Br. 11-12; Pet. Br. 31, 33-34) as the Eighth Circuit's supposed prerequisites to liability under Section 1962(c) are a red herring. The Eighth Circuit did not require any such showing, but only evidence of " 'some participation in the operation or management of the enterprise itself' " (J.A. 275, *quoting Bennett*).[13] The pivotal question here is whether that standard comports with the language, structure, and purpose of Section 1962(c).

B. The "Operation Or Management" Test Is Faithful To The Language, Structure, And Purpose Of Section 1962(c)

Perhaps because petitioners and their amici misinterpret the Eighth Circuit's "operation or management" test as a "control" test, they contend that it is incompatible with the statutory language and legislative purpose. As we show below, that is not the case.

1. The Statutory Language. In construing the meaning of the "conduct" requirement, it is appropriate to begin with the language of the statute itself, *H.J. Inc.*, 492 U.S. at 237, and to construe that language in accordance with its "ordinary meaning." *Russello v. United States*, 464 U.S. 16, 21 (1983). The statutory language should also be examined in light of its context and the structure of the statute as a whole. *King v. St. Vincent's Hospital*, 112 S. Ct. 570, 574 (1991).

[13] In its summary judgment opinion, the district court used the word "control," but then clearly applied the "operation or management" standard of *Bennett*, which contains no reference to "control." J.A. 199. On appeal, the Eighth Circuit applied the *Bennett* standard. J.A. 275. Although the court of appeals characterized *Yellow Bus* as adopting the Eighth Circuit's standard (J.A. 276), there is no reason to believe, as petitioners suggest (Br. 32-34), that the Eighth Circuit substituted the language of the *Yellow Bus* court for its own ruling in *Bennett*. Indeed, petitioners concede (Br. 33) that "it is unclear whether the court adopted all that *Yellow Bus* said," and the Government ultimately concludes (despite its frequent references to "control") that *Yellow Bus* "appears to be even more restrictive than the Eighth Circuit's test." U.S. Br. 11 n.9.

Respondent agrees with petitioners and their amici that, to the extent its meaning can be deciphered, "conduct" as used in Section 1962(c) includes more than "control." That conclusion is based on dictionary definitions of "conduct" that appear to encompass more than the ability to control or direct the affairs of an enterprise (*see* U.S. Br. 10-11; Pet. Br. 22 n.12)[14] and on the congressional "admonition that RICO is to 'be liberally construed to effectuate its remedial purposes.' " *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 498 (1985) (*quoting* Pub. L. No. 91-452, § 904(a), 84 Stat. 947).

Beyond that, however, the statutory language is utterly vague, as evidenced by the multiplicity of standards adopted by the courts attempting to interpret the conduct requirement and by the divergent tests offered by petitioners and their amici. *See* pp. 25-29, *infra*. Petitioners assert that the language is plain (Br. 41) and join the Government in contending (Pet. Br. 23 n.12; U.S. Br. 16) that "conduct" means merely "carrying on" or "carrying out" the affairs of the enterprise. But that formulation simply substitutes one dictionary term for another—an approach that petitioners themselves admit (Br. 41) is not helpful. In the end, both petitioners (Br. 43) and the Government (Br. 17, 18-19) acknowledge that a definitive test of "conduct" eludes their grasp —as it does ours.

But even if substituting "carrying out" for "conduct" provided meaningful guidance in delineating the reach of

[14] Although dictionaries are of course an oft used tool in statutory construction, we doubt their utility in this case. Depending on the dictionary consulted and the particular definition chosen, it is possible to define "conduct" in a manner that would support virtually every interpretation of Section 1962(c) that has ever been put forward. We therefore see little purpose to engaging petitioners and their amici in a "battle of the dictionaries." As we demonstrate in text (*see* pp. 20-22, *infra*), the Eighth Circuit's "operation or management" test is perfectly consonant with the broad dictionary definition of "conduct" contained in the *Oxford English Dictionary* and advocated by the Government.

the statute (and we submit that it does not), that would not mean that the Eighth Circuit's standard is wrong. For the operative phrase utilized by the Eighth Circuit—"'some participation in the operation or management of the enterprise'" (J.A. 275, *quoting Bennett*)—is broad enough to encompass the notion of "carrying out" or "carrying on." To "manage" includes the meaning, "[t]o conduct or carry on (a war, a business, an undertaking, an operation)." IX *Oxford English Dictionary* 292 (2d ed. 1989). To "operate" includes the meaning, "[t]o direct the working of; to manage, conduct, work (a railway, business, etc.); to carry out or through, direct to an end (a principle, an undertaking, etc.)." X *Oxford English Dictionary* 848 (2d ed. 1989). Thus, the Eighth Circuit's standard, applied literally, requires "some participation" in conducting, carrying on, carrying out, directing, managing or working "the affairs of the enterprise itself." The court below was faithful to the literal meaning of "conduct" as interpreted by petitioners and the Government; indeed, the dictionary definitions of these terms—"conduct," "operation," and "management"—are essentially interchangeable.

2. *The Statutory Structure.* In Section 1962(c), Congress established three prerequisites to liability: *first*, the defendant must be "employed by or associated with" an enterprise engaged in, or the activities of which affect, interstate or foreign commerce; *second*, the defendant must "conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs"; and *third*, that participation or conduct must be "through a pattern of racketeering activity or collection of unlawful debt." Contrary to the Government's contention (U.S. Br. 12), the Eighth Circuit's "operation or management" standard is fully compatible with this structure.

Under the court of appeals' standard, a defendant may operate or manage an enterprise "directly or indirectly"; there is nothing in the language of the decision that limits liability to "insiders."[15] Further, the court below explicitly acknowledged that "management" and "operation" may be shared, giving full meaning to the "participation" language of the statute: the defendant need only have "'*some* participation in the operation or management of the enterprise itself.'" J.A. 275 (emphasis added; citation omitted). And equally important, the Eighth Circuit gave full meaning to the "conduct" element of Section 1962(c) by recognizing that mere participation in the affairs of a RICO enterprise is insufficient. *Bennett*, 710 F.2d at 1364 ("[m]ere participation in the predicate offenses listed in RICO, even in conjunction with a RICO enterprise, may be insufficient to support a RICO cause of action. A defendant's participation must be in the *conduct* of the affairs of a RICO enterprise") (emphasis added). As shown at pp. 25-29, *infra*, a fundamental flaw in the other standards advanced by petitioners' amici as definitive interpretations of Section 1962(c) is their failure to ascribe any meaning to the "conduct" requirement.

3. Legislative History. The "operation or management" test also finds support in RICO's legislative history. The Senate and House reports more than "merely track the statutory language" (U.S. Br. 13); rather, they describe Section 1962(c) as "proscribing the *operation* of any enterprise * * * through a 'pattern' of 'racketeering activity.'" S. Rep. No. 617, 91st Cong., 1st Sess. 34 (1969) (emphasis added); H.R. Rep. No. 1549, 91st Cong., 2d Sess. 35 (1970). The Senate Report goes on to state that RICO "attacks * * * corruption in the acquisition or *operation* of business." S. Rep. No. 617, *supra*, at 81 (emphasis added).[16] Moreover, the comments made

[15] *See also Yellow Bus*, 913 F.2d at 953 ("The 'operation and management' standard requirement can as easily be applied to—for example—an organized crime boss who pulls the strings of a corporation as it can to the corporation president himself.").

[16] The Government discounts this passage (Br. 14) by noting that it appears in the Senate Report's discussion of civil remedies and suggesting that its thrust is more pertinent to Section 1962(a),

during the course of floor debate concerning RICO indicate that "operate" (and "manage") are the concepts that Congress had in mind in enacting Section 1962(c). *See* U.S. Br. 14-15 n.13.

4. *RICO's Purpose.* The Eighth Circuit's "operation or management" standard is fully consistent with RICO's major purpose: eliminating "the infiltration of organized crime and racketeering into legitimate organizations operating in interstate commerce." S. Rep. No. 617, *supra*, at 76; *United States v. Turkette*, 452 U.S. 576, 591 & n.13 (1981). In Section 1962(c), Congress sought not to outlaw every predicate act committed in a business setting, but rather to forbid such acts only when they become the vehicle through which a defendant conducts, or participates in the conduct of, the enterprise's affairs. Importantly, however, the Eighth Circuit has construed the conduct element of Section 1962(c) broadly enough to encompass *all* members of an enterprise who participate in carrying out its affairs, even when those members are the "foot soldiers" and "smallest fish." *See, e.g.*, *United States v. Kragness*, 830 F.2d 842, 857 (8th Cir. 1987) (affirming RICO convictions of low level distributors and transporter in illegal drug operation). The Eighth Circuit's standard thereby protects legitimate enterprises from unlawful infiltration at all levels. But when an outside entity's only connection with a legitimate enterprise is its performance for a limited period of time of strictly circumscribed, inherently external activities, such as an independent audit, the entity's connection with the enterprise is entirely too attenuated to raise a concern that the entity might infiltrate the enterprise.

This does not mean, of course, that accounting firms or other entities in the business of providing services

which prohibits a person from using or investing the proceeds of a pattern of racketeering activity "in acquisition of any interest in, or the establishment or operation of, any enterprise." 18 U.S.C. § 1962(a). However, there is nothing in the Report that indicates that its reach is so limited. The passage refers to "Title IX," and not merely Section 1962(a). S. Rep. No. 617, *supra*, at 81.

or goods to other businesses are exempt from RICO. Rather, consistently with Congress' predominant concern about the *operation* of enterprises through a pattern of racketeering activity, the entity can be subject to RICO's extraordinary sanctions only if it can be shown that the entity conducts its *own* affairs through a pattern of racketeering activity. As noted earlier (*see* n.12, *supra*), such an allegation was made in the proceedings below and rejected by the district court, which observed that to the extent Arthur Young's dealings with the Co-op were wrongful, they were aberrant and in no way typical of the firm. Under these circumstances, the particular concerns of Congress in creating RICO's severe remedies are not implicated and the remedies provided by the federal securities laws are fully adequate to address the predicate acts found by the jury in this case.

II. OTHER "CONDUCT" TESTS PROPOSED BY PETITIONERS' AMICI WOULD IMPERMISSIBLY REWRITE THE STATUTE BY ELIMINATING THE CONDUCT REQUIREMENT ALTOGETHER

In a remarkable display of candor, petitioners straightforwardly assert that the conduct requirement "inherently cannot limit RICO in any relevant manner." Br. 20. Similarly, petitioners' amici advance several tests for the conduct requirement of Section 1962(c) that depart dramatically from the plain language of the statute and, in substance, would eliminate the conduct requirement entirely.[17] For that reason alone, the Court should reject them.

[17] These standards, with few exceptions, were neither formulated nor utilized by the courts to address the conduct requirement. Instead, they for the most part address a closely related but nonetheless analytically distinct issue under RICO, the "nexus" requirement—that is, the determination of whether, *given* a defendant's participation in the conduct of the enterprise's affairs, there exists a sufficient relationship between the defendant's racketeering activity and the enterprise to conclude, as the statute requires, that the defendant's participation in the conduct of the enterprise's affairs was *through* the pattern of racketeering activity. In each of the cases in which these nexus tests was articulated, the defendants had

1. *The Cauble Test.* Amicus National Association of Insurance Commissioners urges (NAIC Br. 14-16) the adoption of the "Seventh Circuit" test, which, it turns out, was first articulated by the Fifth Circuit in *United States v. Cauble*, 706 F.2d 1322 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984). In *Cauble*, the court required proof that: (1) the defendant committed the racketeering acts as alleged, (2) the defendant's position in the enterprise facilitated his commission of the racketeering acts, and (3) the predicate acts had some effect on the enterprise. 706 F.2d at 1333.

On its face *Cauble* does not include Section 1962(c)'s conduct requirement; nowhere in the test does the word "conduct"—or even any recognized synonym—appear. If *Cauble* were adopted as the test for "conduct," the effect would be to eliminate that statutory requirement altogether and to impose RICO liability for the mere commission of racketeering acts. That is because having established the predicate acts, a plaintiff would be required to show only (i) that the defendant's association with the enterprise "facilitated" the commission of those acts[18] and (ii) that those acts had "some effect on the enterprise." As the Government observes (Br. 17 n.16), a RICO defendant's "association with an enterprise can be established through mere proof of a transaction with the enterprise." *See, e.g., United States v. Yonan*, 800 F.2d 164, 167 (7th Cir. 1986) ("[t]he cases make clear that the defendant need not have a stake in the enterprise's 'goals,' but can associate with the enterprise by conducting business with it"), *cert. denied*, 479 U.S. 1055 (1987). And proof that a defendant's association with the enterprise "facilitated" the commission of racketeering acts is a virtual given in every RICO case—one need only show that the transactions that establish the defendant's association with the enterprise are the very transactions that establish the predicate acts.

Thus, in the end, as the NAIC forthrightly acknowledges (Br. 15 n.15 (emphasis added)), the *Cauble* test is a mere "affects" test: "outsiders to the enterprise who *affect* its affairs may be reached under section 1962(c)." Under that standard any defendant who "affects" an enterprise through a pattern of racketeering activity—which means all defendants having transactions with the enterprise that constitute predicate acts—would be liable. But that result is utterly inconsistent with the congressional determination that RICO liability may be imposed not for the mere commission of racketeering acts, but only when such acts are the means through which the defendant conducts the affairs of the enterprise. There is simply no justification for the NAIC's attempt to rewrite the statutory language. *See H.J. Inc.*, 492 U.S. at 240-241 & n.3 (rejecting "multiple scheme" limitation on RICO's "pattern" requirement); *Sedima*, 473 U.S. at 495 (rejecting "racketeering injury" requirement); *Turkette*, 452 U.S. at 582-583, 585 (rejecting requirement that the RICO enterprise be a legitimate business).

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substantial day-to-day participation in the carrying out of the enterprise's affairs and therefore would have easily met the *Bennett* standard. *See, e.g., United States v. Scotto*, 641 F.2d 47, 51 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981); *United States v. Provenzano*, 688 F.2d 194, 196 (3d Cir.), *cert. denied*, 459 U.S. 1071 (1982); *United States v. Cauble*, 706 F.2d 1322, 1331, 1339-1341 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984); *United States v. Qaoud*, 777 F.2d 1105, 1107-1108, 1115 (6th Cir. 1985), *cert. denied*, 475 U.S. 1098 (1986); *United States v. Pieper*, 854 F.2d 1020, 1023, 1026-1027 (7th Cir. 1988); *United States v. Yarbrough*, 852 F.2d 1522, 1526-1527 (9th Cir.), *cert. denied*, 488 U.S. 866 (1988).

Without analyzing their analytically distinct origins, petitioners' amici now propose the "nexus" standards set forth in these cases as tests for the "conduct" requirement. As we demonstrate above, using them in that fashion would extend RICO far beyond the purpose of Congress.

[18] In a recent decision, *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 533-534 (5th Cir. 1992) (emphasis added), the Fifth Circuit held that the second prong of the *Cauble* test is satisfied by proof that "the defendant's *association* with the enterprise facilitated the commission of the acts," thereby making it clear that a "position in" the enterprise is not required.

2. The Scotto Test. As the Government notes (Br. 17 n.17), *United States v. Scotto*, 641 F.2d 47 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981), is often cited as setting forth an appropriate "conduct" standard. In *Scotto*, the court asserted that "one conducts the activities of the enterprise through a pattern of racketeering activity when (1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, *or* (2) the predicate offenses are related to the activities of the enterprise." 641 F.2d at 54 (emphasis added). Nowhere in this disjunctive test does the word "conduct" appear. Rather, one is within Section 1962(c) under *Scotto* whenever the predicate offenses at issue are "related to" the activities of the enterprise. Like *Cauble*, *Scotto* is tantamount to a mere "affects" test capable of sweeping into the RICO net those who merely transact business with an enterprise at arm's length. The Government is correct (if somewhat restrained) in observing that *Scotto* "provides little concrete guidance and may suggest overbroad applications of RICO." U.S. Br. 17-18 n.17.

3. The Bank of America Test. Amicus National Association of Securities and Commercial Law Attorneys proposes the standard applied in *Bank of America Nat'l Trust & Savings Ass'n v. Touche Ross & Co.*, 782 F.2d 966 (11th Cir. 1986), as the definitive test of what "conduct" means. NASCAT Br. 30. In that case, the court ruled that "[t]he word 'conduct' in 1962(c) simply means the performance of activities necessary or helpful to the operation of the enterprise." 782 F.2d at 970. The Eleventh Circuit rejected an argument that Congress imposed a conduct requirement, and embraced the observation in *United States v. Watchmaker*, 761 F.2d 1459, 1476 (11th Cir. 1985), *cert. denied*, 474 U.S. 1100 (1986) (citation omitted), that:

> The substantive prescriptions of the RICO statute apply to insiders and outsiders * * * *who participate directly and indirectly in the enterprise's affairs* through a pattern of racketeering activity.

782 F.2d at 970 (emphasis altered). This test too ultimately rewrites the statute: it makes it a violation of RICO to "participate * * * in the affairs of the enterprise" even though Congress chose to require more.

III. INDEPENDENT AUDITORS DO NOT PARTICIPATE IN CARRYING OUT THE AFFAIRS OF THEIR AUDIT CLIENTS AND THEREFORE DO NOT SATISFY THE CONDUCT REQUIREMENT OF THE STATUTE WHEN ENGAGED IN AUDITING ACTIVITY

Despite the virtual impossibility of articulating any bright-line test for the "conduct" requirement of Section 1962(c) in every case (*see* pp. 45-49, *infra*), there exists a wide array of cases in which it is not difficult to determine that the requirement has been met. It is relatively easy, for example, to conclude that Section 1962(c) applies to defendants—whether "insiders" or "outsiders"—who engage in racketeering activity through the use of a wholly criminal enterprise. *See, e.g., United States v. Watchmaker*, 761 F.2d at 1475-1476 (defendants engaged in several acts of drug dealing and other crimes with other members of the enterprise, the affairs of which consisted, *inter alia*, of the sale of drugs). Similarly, there is little question that "insiders"—whether high-ranking or low-level employees—are within the statute's reach when their racketeering activity is intended to corrupt a legitimate enterprise, as in the case of the kickback prosecutions cited by the Government. *See, e.g., United States v. Qaoud*, 777 F.2d 1105, 1107-1108, 1115-1117 (6th Cir. 1985), *cert. denied*, 475 U.S. 1098 (1986).

The situations in which the statute presents the most difficult interpretative problems are those involving outsiders who act independently of a legitimate enterprise; the knotty issue in such cases is determining at what point the activities of those independent outsiders have become sufficiently connected to the enterprise that it is reasonable to treat the outsiders as participating in the conduct of the enterprise's affairs. One point, however, is clear: petitioners, respondent, and the Government agree

that, regardless of the test used to interpret the statute, the customary relationship between independent auditors and their clients does not implicate RICO. U.S. Br. 22; Pet. Br. 23-24, 27, 29. Although petitioners contend (Br. 23-24, 29) that Arthur Young's activities in this case went beyond those of an auditor, that fact-bound contention was correctly rejected by the courts below, as we demonstrate at pp. 38-43, *infra*. For present purposes, we focus on the reasons why the activities customarily undertaken by an independent public accountant, standing alone, do not satisfy the conduct requirement.

A. Auditors Do Not Participate In The Conduct Of Their Clients' Affairs

Generally accepted auditing standards provide a comprehensive framework that defines the activities performed by an outside accountant in the course of an audit. Most importantly, an independent public accounting firm in its auditing role simply expresses an opinion on the client's financial statements. *See* 1 [CCH] AICPA, *Professional Standards*, Statements on Auditing Standards ("SAS") No. 1, AU § 110.02. Independent audits are conducted for the specific purpose of issuing an opinion whether, in the auditor's professional judgment, an entity's financial position and results of operations have been fairly presented in all material respects in the financial statements issued by management.

An audit entails the following steps: First, the auditor establishes the scope of the audit, which requires the auditor to develop a reasonable sampling of transactions to be reviewed and to identify those areas in which there is the greatest likelihood of management error or misrepresentation. Second, having decided the initial scope of the audit, the auditor must then test the client's internal financial controls insofar as he plans to rely on those controls in the course of the audit. If those tests confirm the general reliability of the controls, the auditor may conclude that the extent of the substantive audit tests may be reduced. If, on the other hand, the tests

prove the controls unreliable, the auditor may have to expand the initial scope of the audit and build more substantive tests into the process. Third, the auditor conducts a thorough assessment of the evidential matter obtained during the sampling and testing phases; that assessment enables the auditor to express his ultimate opinion on the question whether the client's financial statements, taken as a whole, fairly present the company's financial position and results of operations in all material respects in accordance with GAAP.

An auditor does all of this at arm's length from the audit client. Public accountants are bound by the AICPA's Code of Professional Conduct to maintain their independence. 2 [CCH] AICPA, *Professional Standards*, Principles of Professional Conduct, Article IV, ET § 55. Rule 101 of the Code implements that principle by prohibiting an auditor from having "any direct or material indirect financial interest in the enterprise" audited (ET § 101.02 101-1.A.1) and from being connected with the enterprise "as a promoter, underwriter or voting trustee, or in any capacity equivalent to that of a member of management or of an employee." ET § 101.02 101-1.B.1. These prohibitions are also contained in the Securities and Exchange Commission's independence requirements for certified public accountants. *See* Regulation S-X, Rule 2-01(b), 17 C.F.R. § 210.2-01.

Professional standards also clearly delineate the respective responsibilities of management and auditor with respect to the client's financial statements:

> The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining an internal control structure that will, among other things, record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements * * *. *The independent auditor may make suggestions about the*

form or content of the financial statements, or draft them, in whole or part, based on information from management's accounting system. However, the auditor's responsibility for the financial statements he has audited is confined to an expression of his opinion on them.

1 [CCH] AICPA, *Professional Standards*, SAS No. 1, § 110.02 (emphasis added). This principle—that the client and its management, not the auditor, bear the ultimate responsibility for the accuracy and adequacy of the client's financial statements—has long had the force of law. *See, e.g., In re Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939); Accounting Series Release ("ASR") No. 62 (1947), Fed. Sec. L. Rep. (CCH) ¶ 72,081; ASR No. 126 (1972), Fed. Sec. L. Rep. (CCH) ¶ 72,148; R. Gormley, *The Law of Accountants and Auditors* 1-22 to 1-23 & nn.47-48.

In light of the foregoing, as both petitioners (Br. 23-24, 27) and the Government (Br. 22) concede, an independent auditor does not participate in the conduct of (or "carry out") the affairs of the client. The client's management engages in transactions, buys and sells assets, and makes day-to-day business decisions in conducting its affairs; the independent auditor is precluded from doing so. The auditor may draft the client's financial statements based on the client's books and records, but the statements are ultimately those of the client's management. And the auditor, in the conduct of *its* affairs, tests the clients records and renders an opinion whether the client's financial statements fairly present the financial position and results of operations in accordance with GAAP.

If there were any doubt about the clear demarcation between an auditor and its client, Congress removed it in enacting the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 354. Under prior law, federal banking agencies had statutory authority to bring certain enforcement actions against an "insured institution" or a "director, officer, employee, agent or other person participating in the conduct of the [institution's] affairs." 12 U.S.C. § 1730(e), (g) (repealed by Pub. L. No. 101-73, 103 Stat. 354). In enacting FIRREA, Congress deliberately "*broaden[ed]* the group of individuals and entities covered" by the agencies' enforcement authority. H.R. Conf. Rep. No. 222, 101st Cong., 1st Sess. 439 (1989) (emphasis added). To effectuate this intent, Congress amended the relevant statutes to encompass accountants when they knowingly or recklessly engage in misconduct that causes significant harm to an insured institution, *but placed them in an entirely separate category from* persons participating in the conduct of the affairs of an insured institution. 12 U.S.C. § 1813(u)(4).[19]

In Congress' view, then, independent accountants do not, merely by engaging in auditing acts, participate in the conduct of their clients' affairs. It is a fundamental principle of statutory construction that "a court should 'give effect, if possible, to every clause and word of a statute.'" *Moskal v. United States*, 111 S. Ct. 461, 466 (1990) (citation omitted). If independent contractors such as accountants were merely a subset of Section 1813(u)(3) —*i.e.*, "person[s] * * * who participate[] in the conduct

[19] Congress created a new statutory term to specify those who are subject to enforcement proceedings, "institution-affiliated party," which it defined to include (12 U.S.C. § 1813(u) (emphasis added)):

> (1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution;
>
> (2) any other person who has filed or is required to file a change-in-control notice with the appropriate Federal banking agency under section 1817(j) of this title;
>
> (3) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate banking agency (by regulation or by case-by-case) *who participates in the conduct of the affairs of an insured depository institution; and*
>
> (4) any independent contractor (*including any attorney, appraiser, or accountant*) * * *.

of the affairs" of an insured institution—Section 1813 (u)(4) would be superfluous. Congress' clear understanding that accountants performing only auditing activity were not covered by that unique phraseology in the banking laws thus sheds considerable light on the meaning of the virtually identical phrase as used in RICO.

In sum, the controlling professional standards and legal principles establish that independent public accountants do not participate in the conduct of their clients' affairs merely by engaging in auditing activity.

B. The Policy Underlying RICO Demonstrates That The "Conduct" Element Of Section 1962(c) Is Not Satisfied By Auditing Activity

Given the limited nature of an auditor's function, one cannot justify the imposition of Section 1962(c) liability on the ground that an auditor has participated in the conduct of the client's affairs merely by engaging in auditing activity. In enacting RICO, Congress attempted to stem the infiltration of organized crime and racketeering into legitimate organizations. *See* p. 24, *supra*.[20] By definition, an independent auditor, merely by

[20] The NAIC's claim that RICO was intended to "snare accounting firms" (Br. 16 n.16) is highly misleading. In fact, two of the three floor debates on which the NAIC relies demonstrate exactly the opposite—*i.e.*, that Congress was concerned that organized crime was infiltrating the accounting profession itself. *See* 113 Cong. Rec. 17949 (1967) ("According to the [National Crime] Commission, organized crime has moved into businesses ranging from accounting to yeast manufacturing."); 116 Cong. Rec. 592 (1970) (listing accounting as one of many businesses and industries in which organized crime has been active). Thus, the NAIC has the infiltrators and those being infiltrated mixed up. The third passage cited by the NAIC is no more convincing; it says: "Indeed, to protect themselves from suit and prosecution, various criminal cartels employ staffs of attorneys, accountants, and business consultants—many of whom do nothing more than work exclusively on the quasi-legitimate business affairs of organized crime." 113 Cong. Rec. 17950 (1967). That activity is far removed from the typical services provided by an independent auditor.

engaging in auditing activity, does not corrupt or usurp the functions of the audit client. What an auditor does—and the most that an auditor is permitted to do and still be considered independent—is test the transactions of the client as reflected in the client's books and records and render a professional opinion. Stated differently, an auditor's conduct of its own affairs through the provision of professional services to a client cannot, as a matter of common sense, be seen as posing any threat of "infiltration" of the client's affairs.

An auditor's role in relation to its client stands in marked contrast to the activities of the defendants in cases exemplifying what the Government indentifies (Br. 19) as "characteristic applications" of RICO. Thus, in the first category, where "the defendant's racketeering activity directly furthers the objectives of the enterprise" (*id.*), the facts of the cases relied on demonstrate that the defendants had substantial, day-to-day participation in carrying out the business of the enterprises alleged.[21] An auditor could conduct none of these activities in relation to its client and remain an independent auditor.

The second and third categories of typical RICO cases identified by the Government (Br. 19-21) are, in fact,

[21] *See United States v. Watchmaker*, 761 F.2d at 1463, 1475-1476 (defendants engaged in several acts of drug dealing and other crimes with other members of the enterprise, the affairs of which consisted, *inter alia*, of the sale of drugs); *United States v. Ellison*, 793 F.2d 942, 945, 950 (8th Cir.) (defendant was founder and leader of white supremacy group and his position enabled him "to assign members to specific jobs and tasks and to direct their activities, both legitimate and illegitimate"), *cert. denied*, 479 U.S. 937 (1986); *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987) (employee of subsidiary participated in the conduct of the parent company by fraudulently procuring contracts for the subsidiary, where a portion of the parent's business was through that subsidiary and the employee was the manager of the subsidiary and acting on the parent's behalf); *United States v. Zauber*, 857 F.2d 137, 140, 150 & n.16 (3d Cir. 1988) (pension fund officials participated in the conduct of a mortgage company by providing it with its only source of capital), *cert. denied*, 489 U.S. 1006 (1989).

but one category—cases in which the defendant corrupts an otherwise legitimate enterprise through a pattern of racketering acts. The only discernible difference between categories "b" and "c" is that "insiders" fall within the former and "outsiders" within the latter.[22] In each case, the defendant, whether insider or outsider, substantially participated in the day-to-day affairs of the enterprise.[23] Indeed, in the bribery cases cited by the Government, the defendant more than participates in the conduct of the enterprise's affairs; through his payments, the defendant seeks to control them.

The activities of the defendants in the Government's category "b" and "c" cases stand worlds apart from what an auditor typically does or is capable of doing. While independent auditors may commit predicate acts during the course of their circumscribed activities, they do not infiltrate the client's business and turn it to illegal ends. Stated simply, auditors are engaged in the conduct of their *own* affairs; that their work may be "necessary or helpful" to or may in some fashion "relate to" or have "some effect" on the affairs of the client enterprise does not mean that the auditor is participating in carrying out its *client's* affairs.

In the end, the Government apparently does not believe that auditor-defendants fall into any of the three categories that it has created. U.S. Br 19. Instead, it concludes with a catch-all category that is singularly unhelpful: according to the Government, in category "d" cases, "the ultimate inquiry is whether the defendant has carried out the affairs of the enterprise through a pattern of predicate

[22] *Compare, e.g., United States v. Qaoud*, 777 F.2d at 1107-1108 (acceptance of bribes by judge), *with, e.g., United States v. Roth*, 860 F.2d 1382, 1383 (7th Cir. 1988) (payment of bribes by lawyer to judge), *cert. denied*, 490 U.S. 1080 (1989).

[23] *See, e.g., United States v. LeRoy*, 687 F.2d 610, 617 (2d Cir. 1982) (defendant used his position as vice president and later business manager of union local to obtain illegal payments and embezzle funds), *cert. denied*, 459 U.S. 1174 (1983); *United States v. Roth, supra*, n.22.

crimes." U.S. Br. 21. Having reduced its analysis to a mere restatement of the statutory language, the Government's position then seems to be nothing more than a thinly-disguised attempt to persuade the Court that auditors may be liable for RICO violations simply by virtue of having committed predicate acts. The Government tells us that, if a outside auditor maintains the professionally-mandated degree of independence from its client, RICO will not be implicated. U.S. Br. 22. If the auditor in some ill-defined way compromises its independence, however, then "it may fairly be characterized as a participant in the conduct of the organization's affairs." *Ibid.* (footnote omitted). In other words, the Government tells us that an auditor that does its job properly need not worry about RICO liability, but an auditor that missteps may find itself liable not only for the predicate acts but for a RICO violation as well.[24]

In our submission, if an auditor engaged to render traditional professional services for its client has committed the necessary predicate acts (such as the jury found to be the case with Arthur Young's audits of the Co-op's financial statements) it may fairly be held accountable for those predicate acts, but no more. *See Sedima*, 473 U.S. at 496 ("mere commission of the predicate offenses" is not in itself a violation of Section 1962(c)). Whatever test might be adopted to elucidate the conduct requirement cannot transform the rendition of professional services to an enterprise—even when those services turn out to have been performed in violation of the securities laws—into RICO violations. Indeed, if "conduct" were really as amorphous as the Government

[24] The Government gives passing nod to the notion that "[i]solated or sporadic misconduct in the course of a client engagement" might not trigger RICO's application. U.S. Br. 22 n.24. According to the Government, however, this is so only because RICO's pattern requirement will not likely have been satisfied in such situations. *Ibid.* While that is undoubtedly correct and is in fact the case here (*see* pp. 43-45, *infra*), it provides no additional guidance on the interpretation of the conduct requirement.

suggests, it surely would run afoul of the Due Process Clause of the Fifth Amendment. *See* pp. 45-49, *infra*.

IV. ARTHUR YOUNG ENGAGED IN NOTHING MORE THAN TRADITIONAL AUDITING ACTIVITY

Petitioners' ultimate contention in this case is that Arthur Young participated in the conduct of the Co-op's demand note program through a pattern of securities fraud. Br. 21-22, 42-43. That contention rests exclusively on Arthur Young's audits of the Co-op's 1981 and 1982 financial statements, for as the district court concluded, there was no evidence to support the claim that Arthur Young played an active role in the purchase or sale of the Co-op's demand notes (*see* p. 3, *supra*), a ruling that petitioners did not appeal. Inasmuch as petitioners themselves concede that the conduct requirement of Section 1962(c) is not satisfied by auditing activity standing alone, the controlling issue here is whether Arthur Young's activity extended beyond auditing.

On a fully developed summary judgment record, and viewing the evidence in the light most favorable to petitioners, the district court (J.A. 7, 199-200) and the court of appeals (*id.* at 274-275) came to the same conclusion—that "Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings." *Id.* at 275.

The district court set forth the precise activities of Arthur Young that petitioners contended went beyond normal auditing (J.A. 199):

> (a) the accountants allegedly created the Co-op's financial statements; (b) the accountants failed to obtain client representation letters; (c) they addressed shareholder meetings; (d) they participated in the creation of condensed financial statements; and (e) the accountants helped the Co-op handle certain matters with government agencies.

None of these activities constitutes a basis for setting aside the conclusion of the courts below that Arthur Young engaged in auditing and nothing more.

A. "Creating the Co-op's Financial Statements." In opposing summary judgment, petitioners argued to the district court that Arthur Young acted as the Co-op's internal accountant by drafting the Co-op's financial statements and by making substantive decisions concerning the accounting method used for the gasohol plant.[25] As noted above (*see* pp. 31-32, *supra*), drafting or assisting in the drafting of the client's financial statements is a core auditing function. Moreover, the summary judgment record contains unrebutted evidence (some of it from petitioners' accounting expert) that establishes beyond a doubt that Arthur Young utilized existing Co-op records in conducting the audits (Reply Mem. Exhibits, Vol. I at 12), and that that is precisely what auditors do.

The contention that the Co-op's management and board of directors were duped on the plant's carrying value—and that the carrying value decision was therefore reached by Arthur Young alone—stands on no firmer ground. Footnote 9 to the Co-op's 1981 financial statements states explicitly that the Co-op acquired legal ownership of the plant in February 1980, but that the carrying value of the plant was nonetheless determined on the basis of the financing provided by the Co-op for the initial construction and revision of the plant. C.A. Jt. App. 250-251. Accordingly, while the board may not have been told in detail about the specific accounting principle used to report the cost of the gasohol plant, it knew the basis of the valuation decision and when the Co-op acquired legal title to the plant. Further, the reference in Arthur Young's audit opinion to footnote 9 to the 1981 financial statements makes it clear that Arthur Young had serious doubts about the recoverability of the Co-op's investment

[25] Plaintiffs' Responding Memorandum to the Motion of the Arthur Young Defendants for Summary Judgment, Nos. 85-2044, 2096, 2155 & 2259 (W.D. Ark. filed September 4, 1986) ("Plaintiff's Summary Judgment Mem."), at 56-62.

in the plant and needed projections and other analyses from management to address that issue. C.A. Jt. App. 235, 250-252. Thus, there is nothing in the summary judgment record to support petitioners' assertion that Arthur Young functioned as the Co-op's internal accountant.

B. The Management Representation Letters. Petitioners also argued to the district court that Arthur Young's failure to secure representation letters from the Co-op's management had the effect of making Arthur Young and not the Co-op's management ultimately responsible for the Co-op's financial statements. Plaintiff's Summary Judgment Mem. 63. That is plainly not the case. As explained earlier (*see* n.10, *supra*), Arthur Young mistakenly thought that it had a signed management representation letter for the 1981 audit, and it did not interpret Kirit Goradia's failure to sign the 1982 letter as a refusal by management to take responsibility for the Co-op's financial statements because Fred Howard, the Co-op's general manager, did sign the 1982 letter.

At *worst*, these facts might show noncompliance by Arthur Young with applicable professional standards.[26] Even that is questionable, however, because petitioners do not contend that management *refused* to sign a representation letter in 1981; the record merely shows that Arthur Young mistakenly believed that it had such a

[26] Professional standards require an auditor to obtain written representations from management concerning evidential matter that the auditor obtains during the course of the audit. 1 [CCH] AICPA, *Professional Standards*, AU §§ 333.01-333.03. The standards further provide that the written representations "should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Normally, the chief executive officer and the chief financial officer should sign the representations." *Id.* at AU § 333.09. Finally, the standards provide that "[m]anagement's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. Further, the auditor should consider the effect of a refusal on his ability to rely on other management representations." *Id.* at AU § 333.11.

letter in its files. As for 1982, "management" did not refuse to sign; instead, Arthur Young concluded that Fred Howard alone was a sufficient representative of management. Assuming *arguendo* that Arthur Young should have treated Goradia's failure to sign the 1982 letter as a refusal to sign by "management," petitioners have done no more than (re)establish part of their case on the predicate acts of securities fraud. They have not to this day explained how the absence of the signed letters transformed Arthur Young into the *de facto* management of the Co-op. The mere commission of predicate acts, without proof of the "conduct" requirement, does not establish a RICO claim. *See Sedima*, 473 U.S. at 496.

C. The Co-op's Annual Meetings. It is commonplace for auditors to speak at shareholder meetings, and the proxy rules of the SEC explicitly acknowledge that role. Thus, 17 C.F.R. § 240.14a-101, Item 9(c) provides that:

> The proxy statement shall indicate (1) whether or not representatives of the principal accountant for the current year and for the most recently completed fiscal year are expected to be present at the security holders' meeting, (2) whether or not they will have the opportunity to make a statement if they desire to do so and (3) whether or not such representatives are expected to be available to respond to appropriate questions.

Thus, the courts below correctly concluded that Arthur Young did not depart from its role as an auditor in addressing the Co-op members at two annual meetings.

D. The Condensed Financial Statements. The condensed financial statements disseminated at the annual meetings were prepared by Kirit Goradia and not Arthur Young, and were based on the audited financial statements drafted by Arthur Young. J.A. 249 n.9. With respect to the 1981 condensed financial statements, the most that petitioners contend is that they were sent to Arthur Young and returned unchanged. Br. 16.[27] As for the

[27] Petitioners also contend (Br. 16) that Arthur Young knew *at that time* that the condensed statements were misleading. As we

1982 condensed statements, Arthur Young informed Goradia that its name should not appear on them because the statements were misleading. J.A. 257. At both the 1982 and 1983 meetings, Arthur Young informed the members that they had been given only condensed financial statements and that the complete audited financial statements were available at the Co-op's offices. J.A. 250, 258. In the end, the contention that Arthur Young participated in the creation of condensed financial statements adds nothing, since those statements were based on (though considerably less accurate than) the complete audited financial statements drafted by Arthur Young.

E. Government Inquiry. The final act of "conduct" considered by the district court was a letter from Arthur Young responding to an inquiry from the United States Department of Agriculture. Pet. Br. 17-18. Although petitioners do not argue that this letter constituted "conduct," the district court considered it (J.A. 199) and concluded that it was not. An examination of the particular communication relied on by petitioners (C.A. Jt. App. 1261-1262), which they blatantly misstate (*see* Reply Mem. Exhibits, Vol. 1 at 10), demonstrates that the district court was correct. That document is a letter dated September 9, 1983, in which Arthur Young, in response to a request from the Department of Agriculture for financial information concerning the Co-op, stated that professional standards prohibited Arthur Young from preparing a review report concerning the Co-op's financial statements because Arthur Young had been required to qualify its audit opinions in light of management's failure to provide the projections and analyses needed to assess the recoverability of the investment in the gasohol plant. Quite clearly, Arthur Young's *refusal* to comply with the USDA request is the very antithesis of participation in the conduct of the Co-op's affairs.

For all of these reasons, the courts below were correct in concluding that Arthur Young engaged in auditing

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have explained earlier (*see* n.11, *supra*), petitioners have misstated the chronology of events.

activity but nothing more. Petitioners' response is to urge that the case be remanded with directions that their RICO claim be analyzed under the "traditional and accepted" meanings of the words used in the statute itself. Br. 41-43. But implicit in that argument, at least in this case, is the notion that *every* RICO claim should be submitted to the jury for consideration in light of these "traditional and accepted" statutory words, which is to say that the courts have no screening function in RICO cases and that every RICO claim against an outside auditor is sufficient as a matter of law whatever the record may reveal. We submit that that is wrongheaded, and that the courts below correctly concluded that auditing activity, standing alone, does not equal "conduct" and that in *this* particular case Arthur Young engaged in audits of the Co-op's financial statements, but nothing more.

V. ARTHUR YOUNG'S AUDITING ACTIVITY DOES NOT SATISFY RICO'S PATTERN REQUIREMENT

In its motion for summary judgment, respondent argued that petitioners' RICO claim was defective because it did not satisfy the pattern requirement of Section 1962(c). Neither the district court nor the court of appeals reached that issue because both concluded that Arthur Young did not participate in the conduct of the Co-op's affairs. J.A. 198-200, 273-277. Although it is not the question presented by petitioners in this case, petitioners' inability to satisfy the pattern requirement provides an alternative ground for affirmance.

H.J. Inc. establishes that *in addition* to the two predicate acts required by the statute, petitioners "must show that the racketeering predicates are related, *and* that they amount to or pose a threat of continued criminal activity." 492 U.S. at 239. Adopting a "common-sense" approach, the Court ruled that a plaintiff can satisfy the "continuity" requirement by showing either a "closed period of repeated conduct, or * * * past conduct that by its nature projects into the future with a threat of repetition." *Id.* at 241.

Here, petitioners can prove neither the presence nor the threat of continued criminal activity that RICO was adopted ~~to attack~~. Where there is no threat of further racketeering, *H.J. Inc.* teaches that "acts extending over a few weeks or months" are not enough. 492 U.S. at 242. That precisely describes Arthur Young's relationship with the Co-op and the nature of the predicate acts at issue in this case. Arthur Young's involvement with the Co-op was sporadic—or, as one court describing an audit relationship stated, "occasional"—consisting of an audit conducted over a period of a few months in early 1982 and again in early 1983. *See Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980). And it bears emphasis that however petitioners may try to dress up their argument, they cannot avoid the fact that their RICO claim essentially relates to one accounting decision concerning one asset of one company: their contention is that, in its first year of auditing the Co-op's financial statements, Arthur Young fraudulently overstated the carrying value of the gasohol plant and drafted false financial statements based on that overstatement and then repeated this same mistake in the next year. "Common sense" dictates that the same act of securities fraud committed in one year and repeated again the following year cannot constitute "a closed period of repeated conduct" (492 U.S. at 241) or "continued criminal activity" (*id.* at 239) within the meaning of RICO. *Cf. Blake v. Dierdorff*, 856 F.2d 1365, 1371 (9th Cir. 1988) (holding that alleged frauds arising out of a single independent audit do not constitute a pattern of racketeering activity).[28] Arthur Young's activity thus stands in dramatic contrast to the allegations held to be sufficient in *H.J. Inc.*: "that at different times over the course of at least a 6-year period the noncommissioner respondents gave five

[28] Indeed, the present case is, for all practical purposes, a single audit case even though Arthur Young served as the Co-op's auditor for two years. Having decided in year one that the appropriate accounting treatment under GAAP was to report the carrying value of the gasohol plant at historical cost, Arthur Young would have had no occasion to revisit that decision in year two.

members of the MPUC numerous bribes, in several different forms, with the objective—in which they were allegedly successful—of causing these commissioners to approve unfair and unreasonable rates for Northwestern Bell." 492 U.S. at 250.

Nor did Arthur Young's activity pose a threat of continued criminal activity. It is undisputed that Arthur Young's relationship with the Co-op ended in the fall of 1983 after Arthur Young indicated that it might render an adverse or disclaimed opinion on the Co-op's 1983 financial statements unless the Co-op took certain steps with respect to the gasohol plant. *See* Tr. Vol. X at 149-151. The Co-op then retained another accounting firm to audit its 1983 financial statements. Accordingly, there could not be, under any circumstances, a threat of continued criminal activity on the facts of this case.

VI. IF SECTION 1962(c) IS CONSTRUED AS ENCOMPASSING MERE AUDITING ACTIVITY IN SOME CIRCUMSTANCES BUT NOT IN OTHERS, THE STATUTE IS IMPERMISSIBLY VAGUE AND VIOLATES THE DUE PROCESS CLAUSE OF THE FIFTH AMENDMENT

Our principal submission is that the conduct requirement of Section 1962(c) cannot reasonably be construed as encompassing the typical professional services provided to a client by an independent auditor. If the Court should conclude that mere auditing activity *can*, under some circumstances, satisfy the conduct requirement, then we submit that it is impossible to find any interpretation of Section 1962(c) that both (1) gives the conduct requirement some meaning, and (2) provides reasonably clear guidance to the public, prosecutors, courts, and juries on the demarcation between auditing activity that does and does not constitute participation in the conduct of the affairs of a client. In these circumstances, Section 1962(c) must be declared unconstitutionally vague.[29]

[29] We also submit that Section 1962(c) is unconstitutional because of the vagueness of its "pattern" requirement, as amply demon-

"[A] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law." *Connally v. General Construction Co.*, 269 U.S. 385, 391 (1926). Because RICO is both a criminal and civil statute, the standard of certainty and specificity for the conduct requirement is high. *See FCC v. American Broadcasting Co.*, 347 U.S. 284, 296 (1954) ("It is true * * * that these are not criminal cases, but it is a criminal statute that we must interpret. There cannot be one construction for the [FCC] and another for the Department of Justice.").

The Court has articulated two primary reasons why vague laws impinge upon fundamental protections provided by the Due Process Clause:

> First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning. Second, if arbitrary and discriminatory enforcement is to be prevented, laws must provide explicit standards for those who apply them. A vague law impermissibly delegates basic policy matters to policemen, judges, and juries for resolution on an *ad hoc* and subjective basis, with the attendant dangers of arbitrary and discriminatory applications.

Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc., 455 U.S. 489, 498 (1982) (citation omitted). *Accord Smith v. Goguen*, 415 U.S. 566, 572-573 (1974) (vagueness doctrine "requires legislatures to set reasonably clear guidelines for law enforcement officials and triers of fact in order to prevent 'arbitrary and discriminatory enforcement'") (footnote omitted); *United States v. Reese*, 92 U.S. 214, 221 (1876) ("It would certainly be

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strated by Justice Scalia's concurrence in *H.J. Inc.*, 492 U.S. at 254-256, in language that we cannot improve upon.

dangerous if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large.").

When considered in the context of RICO, the Court's articulations of the dangers of an impermissively vague statute certainly strike a responsive chord. As has been noted often, Congress intended to use "terms of breadth" in RICO and for these terms to be "liberally construed" to effectuate RICO's purposes. The Constitution, however, does not allow a legislature unfettered freedom to paint with such a broad brush. By casting a net conceivably large enough to catch all possible offenders through its use of imprecise language, Congress may well have impermissively delegated basic policy matters to law enforcement officials and triers of fact for resolution on an "*ad hoc* and subjective basis." In the absence of any reasonable guidelines to provide content to the statutory language, RICO cannot survive under due process of law.

The indefiniteness of RICO's conduct requirement is graphically demonstrated by the veritable kaleidoscope of tests that have been devised by the courts of appeals in their struggle to ascribe some concrete meaning to the statutory language. *See Yellow Bus*, 913 F.2d at 952-954 (canvassing court of appeals cases addressing the conduct requirement). Moreover, when these tests are interpreted as broad enough to encompass, under some circumstances, the typical relationship between client and outside accountant, the invariable result has been that the scope of RICO's conduct requirement is left to the "*ad hoc* and subjective" determinations of finders of fact.[30] Despite widely varying levels of accountant in-

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[30] In contrast, courts that have interpreted the conduct test as raising only the question whether the outside accountant's involvement with its client exceeded the typical professional relationship have been able to decide cases as a matter of law. *See, e.g., Reves*, J.A. 275; *Morin v. Trupin*, 747 F. Supp. 1051, 1066 (S.D.N.Y. 1990); *Goldman v. McMahon, Brafman, Morgan & Co.*, 706 F. Supp. 256, 261-262 (S.D.N.Y. 1989); *Plains/Anadarko-P Ltd. Partnership v. Coopers & Lybrand*, 658 F. Supp. 238, 240 (S.D.N.Y. 1987).

volvement in the client's affairs, courts have ruled that *all* of these cases should go to the jury because there is no ascertainable standard to distinguish between those cases in which the accountant participates in the conduct of the client's affairs from those in which it does not. *See, e.g., Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 534 (5th Cir. 1992) (reversal of summary judgment in favor of auditor because allegations of auditing activity entitled plaintiffs "to take their RICO case to a jury"); *Bank of America*, 782 F.2d at 970 (whether independent auditors meet conduct requirement is "question of fact that may not be addressed on a motion to dismiss"); *Schacht v. Brown*, 711 F.2d 1343, 1345, 1353 (7th Cir.) (accounting firms who audited enterprise and failed to disclose its insolvency "at least arguably" fell within conduct requirement), *cert. denied*, 464 U.S. 1002 (1983); *Gilmore v. Berg*, 761 F. Supp. 358, 363, 375 (D.N.J. 1991) (accountant's preparation of forecast letter, which merely involved one meeting with the client's principal, several hours performing computations, and compensation of $3,000, was "sufficient evidence to let the jury decide" whether the conduct requirement was met); *Baggio v. EC Solar, Inc.*, No. 88 C 1893, 1990 U.S. Dist. LEXIS 5569, at *3-*4, *27-*28 (N.D. Ill. May 8, 1990) (preparation and mailing of partnership tax returns precluded granting of motion to dismiss); *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1494 (D. Or. 1985) (assistance in SEC registration, preparation of financial statements and quarterly aging reports, and single speech at annual meeting sufficient to raise issue of fact as to whether independent auditor was "substantially connected" to client).

The inherent unfairness and arbitrariness of this state of affairs is not likely to improve under any of the interpretations of the conduct requirement that have been offered by petitioners and their amici. For example, petitioners ask the Court to adopt a regime under which the specific facts of each case are simply plugged into the statutory language and juries are left to decide on

a case-by-case basis whether the accountant has "conducted" its client's affairs. Br. 21-22, 42-43. Alternatively, petitioners and their amici offer interpretations that would read the conduct requirement right out of the statute. *See* pp. 25-29, *supra*. All outside accountants, as well as most other outside providers of goods and services to legitimate enterprises, would be subject to RICO liability. While dropping the conduct requirement certainly eliminates its vagueness, Congress clearly intended the conduct requirement to have *some* meaning.

In sum, Congress provided only two guideposts for interpreting the conduct requirement of Section 1962(c). First, it intended for "conduct" to have some meaning and therefore did not intend for persons who merely "participate in" a legitimate company's affairs, even through a pattern of racketeering activity, to fall within RICO's net. Second, Congress intended for some outsiders to be covered by RICO, but provided little or no guidance as to which ones. If the Court should decide that the statute can encompass the typical relationship between a legitimate enterprise and its outside auditor, then the accounting profession will be left adrift in a sea of ambiguity where the statute may or may not cover any particular accountant and there is no prospect of any reasonable limits on the *ad hoc* and subjective determinations of prosecutors, plaintiffs' lawyers, judges, and juries. This state of affairs cannot be tolerated under the constitutional guarantee of due process of law.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

18 U.S.C. § 1962 provides:

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Code, to use or invest, directly or indirectly, any part of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participation in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any pattern o[f] racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsection (a), (b), or (c) of this section.